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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/188

3:00 p.m., December 27, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	M. Lundsager, Temporary
	G. Ercel, Temporary
	S. de Forges
M. Finaish	
H. Fujino	
	B. Goos
Huang F.	
	H. A. Arias
	M. Foot
	O. Isleifsson, Temporary
	G. W. K. Pickering, Temporary
	G. D. Hodgson, Temporary
	A. Abdallah
	C. A. Salinas, Temporary
	J. E. Suraisry
	G. Ortiz
	J. de Beaufort Wijnholds
	A. V. Romuáldez
	H. Alaoui-Abdallaoui, Temporary
	A. Vasudevan, Temporary
S. Zecchini	N. Coumbis

A. Wright, Acting Secretary
S. L. Yeager, Assistant

Also Present

IBRD: F. Jaspersen, Latin America and Caribbean Regional Office; R. Key, East Asia and Pacific Regional Office; M. Palein, West Africa Regional Office. African Department: G. E. Gondwe, Deputy Director; M. Allen, E. A. Calamitsis, C. V. Callender, M. E. Edo, J. Harnack, I. S. McCarthy. Asian Department: Tun Thin, Director; J. R. Márquez-Ruarte, R. C. Williams, K. Yoshinari. Exchange and Trade Relations Department: M. Guitián, Deputy Director; G. G. Johnson, R. P. Kronenberg, M. H. Rodlauer. Legal Department: J. K. Oh, S. A. Silard, J. V. Surr. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola, C. Cha, C. M. de Rosa, R. A. Elson, S. Umana. Advisors to Executive Directors: W.-R. Bengs, G. R. Castellanos, H.-S. Lee, G. Nguyen, J.-C. Obame, M. Z. M. Qureshi, N. Toé. Assistants to Executive Directors: J. R. N. Almeida, R. Fox, N. Haque, Z. b. Ismail, H. Kobayashi, W. K. Parmena, M. Rasyid, V. Rousset, H. van der Burg.

1. EL SALVADOR - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/187, 12/27/85) their consideration of the staff report for the 1985 Article IV consultation with El Salvador (SM/85/315, 11/26/85). They also had before them a report on recent economic developments in El Salvador (SM/85/329, 12/16/85).

The staff representative from the Western Hemisphere Department remarked that available statistical evidence indicated that despite the political situation, financial saving in El Salvador was responsive to interest rate changes. Following an increase in the interest rate on savings deposits and short-term time deposits by two percentage points and the elimination of the ceiling on time deposits of one year and over early in 1982, the growth of time and savings deposits had accelerated in 1982 and 1983. By contrast, following the reduction in interest rates by percentage points and the reinstatement of the ceiling on short-term time deposits in March 1984, the growth of time and savings deposits had decelerated considerably in 1984 and 1985.

At present, the nominal interest rate on time deposits of one year or more was only 13 percent, while the inflation rate was 30 percent, the staff representative noted. After decreasing considerably from 1981 to 1984, private capital outflows had started to increase slightly in 1985, in part owing to highly negative interest rates. Thus, negative interest rates appeared to have had some adverse impact on financial savings as well as the movement of private capital. A sufficiently flexible interest rate policy should help promote the accrual of financial savings and allocate credit more effectively.

Private sector investment had been recovering slowly since 1983 and was mainly directed to domestic demand, the staff representative stated. The slow recovery reflected some uncertainty within the private sector, in part due to the absence of a clear government policy for the medium term. In recent months, however, the relationship between the public and private sectors had improved somewhat. Furthermore, if the package of measures that Mr. Pérez had outlined were implemented soon, private sector confidence should strengthen.

Labor unions in El Salvador were not as organized or as aggressive as in other countries, the staff representative observed. Despite a 20 percent decline in real wages, there had been no social disorder.

The 1986 budget contained no provision for wage increases or for an additional transfer to the Agrarian Reform Institute (ISTA), the staff representative noted. However, according to some reports, public sector wages would increase by 100 colones per month starting in 1986, or about 12 percent in nominal terms. Although wages in real terms were projected to fall in 1986 owing to the rate of inflation, which was expected to be

at least 20 percent in 1986, the staff would still caution the authorities to limit wage increases to the amount already announced in order to maintain the fiscal deficit at a manageable level and contain inflationary pressures.

The medium-term projections showed a $125 million financing gap for 1985, a large portion of which was expected to be financed by official grants, the staff representative indicated. However, supplementary U.S. AID grants for 1986 were likely to be less than expected a few months previously and, as a result, further adjustment measures would be needed to achieve the targeted improvement in the balance of payments.

The volume of imports had been growing at an annual rate of 4 percent in the past two years, while real output had increased at a rate of 1 1/2 percent, implying an import elasticity of 2-3 percent, the staff representative continued. However, over a 20-year period, the elasticity of imports was a further indication that credit policies had been expansionary.

To strengthen El Salvador's external position, efforts to promote and diversify exports were urgently needed, the staff representative remarked. In that regard, it was encouraging that exports to third countries had started to grow rapidly, thereby offsetting the decline in exports to the rest of Central America. Structural changes should be adopted, preferably with the technical assistance of the World Bank, to enhance El Salvador's competitiveness abroad. In that regard, a substantial reduction in effective tariff protection in line with reform of the customs tariffs of the Central American Common Market would be appropriate.

Mr. Pérez said that he wished to thank his colleagues for acknowledging the severe constraints that El Salvador was facing in their assessment of the country's economic performance, and for recognizing that, in spite of the adverse environment, El Salvador had made some headway during 1985. While some slippages had occurred in the area of monetary policy during the first half of 1985, the authorities had attempted to correct those slippages through the measures adopted since June. Moreover, in other economic areas where temporary slippages might have required longlasting and painful measures to address the situation--particularly public sector or wage policies--progress had been achieved as a result of the authorities' firm and unwavering policy stance. Table 2 of the staff report showed that the public sector deficit had been declining continuously since 1981. Also, since 1981 wages had fallen by 35 percent in real terms to the level prevailing in the early 1970s. Finally, the acceleration of the process leading to the unification of the exchange rate system had been another positive development in 1985.

Regarding prospects for 1986, the gradual approach the authorities were pursuing to correct economic imbalances included the possibility of adopting an adjustment program in 1986, and it was encouraging that Executive Directors considered that approach to be appropriate, Mr. Pérez

continued. His authorities attached great importance to the opinion of the Executive Board, and he was sure that the support of the Fund would help a great deal in carrying out the program.

The appropriateness of a tax on windfall profits from coffee exports resulting from the recent exchange rate adjustment has been questioned because of its possible negative impact on exporters, Mr. Pérez recalled. His authorities considered that tax measure as temporary. Moreover, coffee prices were at present experiencing a recovery in the international market, which already represented an adequate incentive to exporters. In the circumstances, his authorities considered that the extraordinary profits stemming from the unification of the exchange rate should be directed toward improving the financial position of the public sector.

An Executive Director had indicated that a faster pace of adjustment might be more appropriate than the authorities' gradual approach, Mr. Pérez continued. He observed that gradualism versus short-term, abrupt adjustment to correct economic imbalances was a common issue in Executive Board discussions. It was well known that abrupt adjustments usually led to social unrest. In the particular circumstances of El Salvador, social unrest as a result of a heavy increase in the fiscal burden or a sharp decline in wages in real terms might exacerbate guerrilla activity. That, in turn, might lead to an increase in defense-related expenditures, thereby offsetting the initial beneficial effects of adjustment. Furthermore, the overall adjustment strategy would suffer a serious setback. Accordingly, he considered that the gradual approach being taken by his authorities was a realistic one.

As for the fiscal package for 1986, it had been suggested that action should be taken with respect to the prices and tariffs of the public enterprises, Mr. Pérez noted. In that regard, he was pleased to inform the Board that one of the measures contemplated in the program for 1986 was a significant adjustment of public enterprise tariffs to fully cover their operating costs.

The Acting Chairman made the following summing up:

> Directors noted the recovery of output that began in 1983 and the significant efforts made by the Salvadoran authorities to maintain a growing economy and a stable financial environment despite the continuation of internal security problems and adverse external factors. While also noting the reduction in the overall public sector deficit as a percentage of GDP since 1981, Directors expressed concern about the strong expansion of bank credit in the past two years which, in their view, represented a reversal of the stabilization effort of previous years and contributed to the rise in the rate of price increases and a weakening in the balance of payments. Directors therefore welcomed the authorities' intention to pursue more restrictive financial policies. Strict restraint on monetary expansion was seen as the most urgent need. The persistence of negative real

interest rates was regarded by some Directors as having serious adverse effects on financial flows; they considered that positive real interest rates would facilitate a more efficient allocation of credit, stimulate the growth of financial savings, and dampen capital outflows. Other Directors, however, were not convinced that higher interest rates would increase savings in the current circumstances.

Directors welcomed the progress made in reducing fiscal imbalances in recent years through restraint in nondefense expenditure and strengthening of the tax effort. They observed, however, that the overall fiscal deficit continued to absorb a significant portion of savings, with negative effects on private investment, price performance, and the balance of payments. Concern was also expressed about the budget prospects for 1986 in the light of pressures for increased current expenditures, particularly for higher public sector wages. Directors pointed to the benefits that would be obtained if the overall fiscal deficit were limited to an amount that could be financed by available foreign resources on a sustainable basis. Directors also stressed the need to strengthen public sector savings to finance an increasing proportion of public investment and thus to make available more private resources to support a recovery in private investment. In this connection, Directors welcomed the plans to introduce a series of new tax measures, but doubts were expressed about whether some of the measures were appropriate and whether sufficient additional revenue would be raised. Most speakers emphasized the need for price adjustments in the public enterprise sector to increase its capacity to support investment while reducing its reliance on transfers from the Central Government.

Directors welcomed the actions taken by the authorities since last year to enlarge the scope of the parallel exchange market. However, to restore a relative price structure that would contribute to efficiency in resource allocation, Directors urged the authorities to reunify the exchange system at a rate that would permit the elimination of exchange restrictions, including external payments arrears, and would help to put the balance of payments on a solid footing. Directors observed that exchange rate unification should be accompanied by financial and wage policies that would keep down the rate of inflation and facilitate the achievement of a viable balance of payments.

It was recommended that the next Article IV consultation with El Salvador be held on the standard 12-month cycle.

2. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1 AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATION

The Executive Directors gave substantive consideration to the Managing Director's complaint under Rule K-1 with respect to Somalia's overdue obligations to the General Department (EBS/85/235, 10/25/85; Sup. 1, 11/20/85; and Sup. 2, 11/27/85) and the notice of Somalia's failure to settle a Trust Fund obligation (EBS/85/269, 12/16/85), together with the proposed decision (EBS/85/286, 12/20/85).

Mr. Finaish said that he wished to emphasize, as he had a month previously when the Board had noted the Managing Director's complaint against Somalia (EBM/85/170, 11/25/85), that the Somali authorities appreciated fully the seriousness with which the Fund viewed the problem of overdue obligations. They also recognized that the Fund's constructive role in assisting member countries was contigent on members being current in their financial obligations. Although it had not been possible for Somalia to become current before the present meeting, the authorities wished to assure the Board that they were doing their utmost to reach a point, as soon as possible, where full settlement of obligations could be made.

Economic developments in Somalia had been subject to the exceptional circumstances prevailing over the past two years, Mr. Finaish observed. As noted in the authorities' telex to the Managing Director (Attachment IV of EBS/85/286), exogenous developments had affected exports severely and had created a serious balance of payments problem which the authorities were still trying to deal with. The problem had been further compounded by disappointing flows of balance of payments assistance in 1985. The latter development had been a main factor in the depletion of the foreign exchange reserves and the emergence of arrears to the Fund. It was particularly unfortunate that those developments had occurred at a time when Somalia, which had had a very good adjustment record in the past, was embarking on a broad-based structural adjustment program supported by the Fund.

The Somali authorities were determined to proceed with a policy of adjustment in the context of the current stand-by arrangement, Mr. Finaish remarked. They realized, of course, that the review under that arrangement could be completed only after the full settlement of arrears to the Fund. Bridge financing to become current with the Fund could be made available to Somalia once full understanding on policies had been reached with the staff. The authorities hoped that the technical discussions scheduled to take place in Mogadiscio in the near future would lead to such an understanding. In that regard, he noted that the broad elements of the main policies had, to a large extent, already been agreed with the staff during the Annual Meetings and subsequently in Paris in November.

The Somali authorities wished to assure the Board that they were giving priority to the question of overdue obligations, Mr. Finaish concluded. Looking beyond the immediate problem, which they hoped would be settled soon, the authorities also wished to emphasize the importance of

adequate donor support of their efforts. The broad support which Somalia's three-year investment program had received in the Consultative Group meeting in Paris the previous month, if translated into a flexible disbursement of aid both in terms of timing and form, would contribute significantly to the authorities' adjustment efforts and to the avoidance of payments arrears in the future.

Mr. Goos recalled that on a number of occasions recently he had elaborated his grave concerns about the adverse implications of arrears to the Fund for both the overdue member and the Fund itself. Those concerns were increasing with the growing incidence of arrears, and they certainly applied to the present case, considering Somalia's disquieting history of repeated difficulties in discharging its financial obligations to the Fund in a timely fashion. He was particularly concerned that since the Board had noted the recent complaint, Somalia had failed to make any payments on its overdue obligations in the General Department and with regard to the Trust Fund.

Nevertheless, there had been some positive developments, including the recent settlement of Somalia's overdue obligations in the SDR Department, as well as the authorities' active cooperation with the Fund in trying to overcome their financial difficulties, Mr. Goos added. Those developments, as well as the authorities' intention to seek bridge financing in order to clear the arrears to the Fund, seemed to indicate their willingness to come to an early normalization in their relations with the Fund. Against that background, he was prepared to support the proposed decision to restrict Somalia's access to the Fund's general resources, and also the maximum review period of three months, on the clear understanding that the authorities should do everything possible to enable the prompt settlement of the overdue obligations.

Ms. Lundsager said that she endorsed Mr. Goos's comments. Also, discussions had been continuing between the staff and the Somali authorities for several months, and she wondered if there had been any indication that agreement on an adjustment program could be reached during the next staff visit to Somalia.

The staff representative from the African Department responded that the staff expected to reach understandings with the Somali authorities during their forthcoming visit. The authorities had used the delays encountered during a recent staff visit to gain the necessary political support within the Cabinet for the measures that had been previously discussed and agreed with the Minister of Finance and the Governor of the Central Bank. Indications were that the commission assigned by the Cabinet to discuss those measures favored their acceptance. Nonetheless, many imponderables remained. When the staff visited Somalia they would probably find that some of the figures underlying the agreements had changed and that the actions previously discussed with the authorities might need to be strengthened. The authorities were of course aware that delays could result in a need for further adjustment measures.

Mr. Suraisry said that he supported the proposed decision, and hoped that Somalia would soon discharge its overdue financial obligations to the Fund so that it could once again take advantage of the valuable services that the Fund provided. In that context, he had found Mr. Finaish's statement reassuring.

Mr. Huang remarked that the nature of the discussions with the Somali Government indicated that the failure to repay overdue obligations to the Fund was the result of an acute shortage of foreign reserves rather than the unwillingness of the Somali authorities to fulfill their commitments. Accordingly, he supported the proposed decision.

Mr. Foot said that he wished to associate himself with Mr. Goos's remarks and that he supported the decision. In future, information on when repurchases and charges would come due would be helpful in determining the period to be allowed before a review of a decision on overdue obligations.

Mr. Hodgson said that he supported the proposed decision. He wondered whether any progress had been made in marshaling donor support and what amounts might be available to Somalia to reinforce any economic policy measures that were taken.

The staff representative from the African Department noted that during a Consultative Group meeting for Somalia held in November, the authorities had received considerable donor support. One difficulty, however, was the type of assistance that had been marshaled. Although considerable assistance had been promised in food and for projects, the assistance promised in the form of currency or petroleum products--which provided more direct balance of payments support--had fallen short of the World Bank's expectations. However, two major donors had not yet given firm commitments, and it was hoped that early in 1986 they would come forward with the type of assistance desired. The donors had also indicated that they were looking for an arrangement with the Fund in support of Somalia's adjustment program as well as a favorable review by the World Bank of Somalia's investment budget for 1986 in order to effect their assistance. Thus, delays in reaching agreement with the Fund not only would affect the Fund's ability to provide assistance to Somalia, but it might also lead to delays in assistance from other sources.

Ms. Lundsager remarked that in light of the comments made by the staff representative, she wished to make explicit her understanding that there was some confidence that the matter of donor assistance would be resolved fairly quickly. She supported the proposed decision in the hope that those difficulties would be resolved within the coming three months.

The Executive Board then took the following decision:

1. The Managing Director has reported under Rule K-1 of the Fund's Rules and Regulations to the Executive Board the facts on the basis of which it appeared to him at the dates of these reports that Somalia was not fulfilling its obligations under the Articles of Agreement and submitted a complaint on October 25, 1985 (EBS/85/235, 10/25/85) and a notice on December 6, 1985 (EBS/85/269, 12/6/85) in accordance with these Rules. The complaint under Rule K-1, as amended, was that as of November 25, 1985, Somalia was not fulfilling its obligations relating to repurchases and the payment of charges in the General Department in the total amount of SDR 12,021,674. Furthermore, the Managing Director added to his complaint a notice of the facts on the basis of which it appeared to him that, as of December 6, 1985, Somalia was not fulfilling its obligations under Decision No. 5069-(76/72) with regard to the Trust Fund to repay a disbursement in the total amount of SDR 970,900. These facts, and the complaint and notice of the Managing Director, were communicated to the authorities of Somalia on November 25, 1985 and December 11, 1985, respectively.

2. Taking into account that no further obligations of Somalia have become overdue since November 25, 1985, and that no payments have been made by Somalia, Somalia's overdue obligations to the Fund now total SDR 12,021,674 in the General Department, and SDR 970,900 under the Trust Fund.

3. Having considered the reports of the Managing Director, the complaint and the notice, and the views of Somalia, the Fund finds that Somalia has failed to fulfill its obligations under the Articles of Agreement and the Trust Fund as stated in paragraphs 1 and 2 above.

4. The Fund regrets the nonobservance by Somalia of its obligations and urges Somalia to resume their observance forthwith. The Fund decides

(a) pursuant to Rule K-2 of the Fund's Rules and Regulations that Somalia shall not make use of the general resources of the Fund until such time as Somalia has become current in its obligations under the Articles of Agreement relating to repurchases and the payment of charges in the General Department, and

(b) if Somalia were otherwise eligible to make use of the general resources of the Fund, to take into account the existence of any overdue obligation to the Trust Fund in considering any request by Somalia for the use of the general resources.

5. The Fund shall review this decision within a period of three months from the date of the decision.

Decision No. 8164-(85/188) G/TR, adopted
December 27, 1985

APPROVED: AUGUST 15, 1986

JOSEPH W. LANG, JR.
Acting Secretary